

INITIAL STATEMENT OF REASONS FOR THE AMENDMENT OF REGULATION SECTION  
17951-4 AND THE ADOPTION  
OF REGULATION SECTION 17951-6

PUBLIC PROBLEM, ADMINISTRATIVE REQUIREMENT, OR OTHER CONDITION OR  
CIRCUMSTANCE THAT THE REGULATION IS INTENDED TO ADDRESS

Existing Regulation section 17951-4 addresses the source of income from sole proprietorships and partnerships for the purpose of taxing nonresident individuals. It was adopted prior to California's conformity to the federal treatment of S corporations and prior to the time that limited liability companies came into existence. The section does not expressly provide guidance for the taxation of individual S corporation shareholders or limited liability company members.

Existing Regulation section 17951-4 states that the source of nonbusiness income from a multistate partnership subject to tax in the hands of a nonresident partner is determined by the use of corporate allocation rules. It does not address the source of such income from a partnership conducting business in one state only or from a sole proprietorship wherever its business is conducted. Section 17952, Revenue and Taxation Code, and decisional law provide for the use of personal income tax sourcing rules under these circumstances.

Existing Regulation section 17951-4 does not expressly require that nonresident individuals combine and apportion income from interests in separate businesses which make up a single unitary business. Such reference is made indirectly by reference to case law and the corporate apportionment and allocation rules. Neither does the existing section provide a threshold below which partners, S corporation shareholders and limited liability members do not generally combine unitary interests.

New Regulation section 17951-6 addresses how to source income of a nonresident individual with income from a covenant not to compete in California. While the sourcing rule prescribed is the same general rule adopted by the State Board of Equalization, the decisions are in a summary format and cannot be cited as precedential authority.

SPECIFIC PURPOSE OF THE REGULATION

The purpose of the proposed amendment to Regulation section 17951-4 is to apply the partnership and sole proprietorship rules in determining the source of income of nonresident S corporation shareholders and limited liability company members. The purpose is also to require the use of personal income tax rules in determining the source of nonbusiness income in all situations. The purpose is also to provide direct authority for requiring nonresident individuals to combine interests in separate businesses which make up a single unitary business, and guidance as to the methodology to be used. It will also provide an ownership interest threshold below which individuals whose interests are part of a unitary business will not normally be required to combine.

The purpose of the new Regulation section is to require the use of a particular methodology consistent with the existing litigating position of the Franchise Tax Board and Board of Equalization decisions, regarding income from a covenant not to compete in California. It permits the Franchise Tax Board to forgo taxation of a covenant not to compete in the circumstance where California would be prohibited by federal statutes or the U.S. or California Constitution and provides for alternative methods if the general rule results in distortion.

NECESSITY

The existing Regulation section 17951-4 needs to reflect the sourcing rules applied to owners of all pass-through entities and not just partnerships. It also needs to be amended to adopt the use

of personal income tax sourcing rules for assigning nonbusiness income in all circumstances to ensure consistent treatment of all nonresident individuals, irrespective of the type of entity they choose. It further needs to provide direct authority for combining unitary interests of nonresident individuals and to allow those with a small ownership interest in pass through entities to avoid the burden of examining whether a unitary business exists. Finally, there needs to be authoritative guidance as to how income from a covenant not to compete in California should be sourced, and provisions made to deviate from the general rule when taxation is prohibited or if the application of the general rule creates distortion in a particular circumstance.

#### TECHNICAL, THEORETICAL, AND/OR EMPIRICAL STUDIES, REPORTS, OR DOCUMENTS

In proposing these regulatory changes, the Franchise Tax Board did not rely upon any technical, theoretical, or empirical studies, reports, or documents.

#### ALTERNATIVES TO THE PROPOSED REGULATORY ACTION THAT WOULD LESSEN ANY ADVERSE IMPACT ON AFFECTED PRIVATE PERSONS OR SMALL BUSINESS

In accordance with Government Code section 11346.5(a)(12), the Franchise Tax Board has determined that no alternative considered by it would be more effective in carrying out the purpose for which the action is proposed or would be as effective and less burdensome to affected private persons than the proposed regulatory action. In addition, because the proposed regulatory action generally pertains to individuals having interests in multijurisdictional business entities, it will have only a minimal impact on small business.

#### ADVERSE ECONOMIC IMPACT ON BUSINESS

The Franchise Tax Board has determined that the proposed regulatory action will not have a significant adverse impact on business.